Lending Risks in Retail Banking & Non-EM
Practical Examples

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What is a crisis in Retail Banking?

- Completely different ball game.
- Affected parties are not “deep pockets” sophisticated investors. Affected parties are “Joe Blogs”, widows, orphans, white collar workers, low income families, pensioners, nurses, teachers, etc …
- Typically not one but several events that have a compounding effect over time.
- Sometimes but not always associated to economic indicators.
- In fact, good economic conditions are sometimes an indicator of poor lending practice.
- Regulatory or legal changes can often be a trigger.
- Market behaviour must be factored in.
- No two crisis are the same, some similar characteristics, but no text book exists.
Case Study #1

Strategy to Match Market Growth

Korea
Case Study # 1

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<thead>
<tr>
<th>Background</th>
<th>Strategy</th>
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<td>• 2010-2014: Korean banks pursued high growth strategy in household debt in support of income growth, following government intervention in large corporations debt levels post the 1997 Asian crisis.</td>
<td>• 2005: Acquisition of Korea’s 7th largest bank with 6% market share, 10% of branches and 8% of mortgage market.</td>
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<td>• 2000-2012: Average increase in household debt of ~13% pa vs average annual GDP growth of ~6%.</td>
<td>• Biggest foreign investment in South Korea’s financial sector. Bank paid 1.87x book value vs Korean banks trading at 1.1x at the time.</td>
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<td>• 2012: Household debt pile reached 164% of disposable income (2004: ~103%, 2011: 135%), or 300% of GDP.</td>
<td>• Bank strategy: upgrade business offering in consumer loans, credit cards, mortgages for SMEs.</td>
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<td>• Comparative data: US: ~130% at height of 2008 financial crisis, OECD: ~130% in 2012.</td>
<td>• 2011/12: Request to review lending criteria in the face of increased competition.</td>
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<td>• 2012: Korea sovereign public credit rating upgrade to AA-, while citing level of household debt a key risk.</td>
<td>• Reviewed criteria included:</td>
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<td>• Industry growth driven by non bank finance institutions.</td>
<td>- Lower income threshold</td>
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<td>• Lack of regulatory oversight on non bank lenders — leading to incomplete national consolidated consumer credit information in credit bureaus, resulting in institutions issuing debt to same customer simultaneously.</td>
<td>- Increased debt: income ratio to 300%, bullet repayment, increased amount</td>
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<td>- Risk price based on historical risk profile, but product offered to different segment</td>
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What Happens Next?

• 2012: Presidential election returned a newly elected President, effective February 2013. New President’s abiding campaign theme was economic equality.

• 2013-2015: Level of impairment at Bank’s consumer finance unit increases.

• 2013: Government’s “National Happiness Fund” lands. Main objective is to help heavily indebted low-income earners. Programs included:
  - Fund to purchase overdue loans at 10% of face value – meaning banks writing off 90%
  - Lenders obliged to sell loans to the fund if borrower applies for debt restructuring
  - Conversion to lower interest rate bearing loans
  - Original lending institution to provide credit recovery assistance
  - Converting high-interest loans to lower-interest

• Bank’s Korean unit records operating loss in 2013 vs similar sized profits the previous year due to provisions from consumer business. Group took US$1bn write down on the value of Korean business.

• Accounting metrics and economic metrics not aligned, lagged losses with no compensating revenue.

• Social stigma of insolvency removed, banks with biggest share of customer wallet left reeling with losses.

• 2014: Bank sold its savings and consumer finance operations to third party and closed ~25% of branches.
What did we learn?

• Politicians and governments will do what they want, when they want in order to further political ambitions rather than do what is right for the economy/country. Pay attention to social-political agendas!

• Combination of widening inequality, stagnant incomes, unemployment and rising debt, resulted in low-income earners having to borrow to finance their living costs. The promise to correct these swept the new President to power.

• While weakening underwriting changes may initially defend market share and income, these inevitably also result in:
  ➢ Biased towards higher risk and without hard limits
  ➢ Accounting measures (P&L) not being aligned to economic measures (Economic Profit)

• Effective use of external data/information is a key differentiator:
  ➢ The data points on the “boiling pot” of household debt level were there for all to see!
  ➢ One foreign bank avoided the crisis with effective use of triple bureau information to assess overall debt.

• Product suitability is a key assessment.

• Last but not least, customer indebtedness and debt servicing ability does matter!
Case Study #2
New Country Entry

Thailand
Case Study # 2

**Background**

- Asian Financial crisis of 1997/98 caused by premature financial liberalisation without established regulatory regime, inadequate exchange rate regime, deteriorating balance of payments and high level of $ borrowings.

- Thailand first “one to go”, and quickly went from “flavour of the month” to “stink of the month”. Economy shrunk by 10.5%, ~50% of bank loans became non-performing, unemployment rose to 8.5%.

- 1999: Economy shrunk by a further 2%, unemployment rose to 9.5%.

- 2002: Standard of living back to pre-crisis levels. However, Thailand unable to compete with cheap labour from China, Vietnam and India.

- 2001-04: economy grew moderately, but slower than in the boom years of H1’90’s. Long-term shift from agriculture to manufacturing and services continued.

**Strategy**

- Bank present in Thailand since 1989 in Bangkok.

- In 1999 acquired medium-sized bank with majority of branches in Bangkok, by far the largest banking market in the country.

- 2013: Announced major unsecured lending growth strategy, projecting 30% growth over next 5 years.

- Expand business outside the metro cities in to towns/areas in up country locations.

- Product structure resembling a loan product with upfront disbursal of loan amount with ability to withdraw additional cash from ATMs.

- Target market expansion and product structure changes done to maximise growth impact (sounds familiar!!!).
What Happens Next?

• Expansion in regions where bank had no presence.
• Revenue increase in year 1 with lagged losses in year 2 and 3.
• Product structure and target strategy sourced a very different risk profile than what was baked in the assumptions – leading to higher than expected losses and lower than expected realised revenues.
• Inability to contact and connect with customer in market locations where there was no bank presence.
• Risk assessment on the product offered was done on the same basis of an instalment loan although the product was a revolving line of credit.
• Misaligned tracking and profitability metrics – early identification of key metrics would not only have reduced losses but would have saved the whole country business from being shut down.
• Score cards used to risk score the portfolio based on instalment loans rather than revolving credit.
• 2016: Bank sold its retail unit at a deep discount to a local banking group after realising there was no competitive advantage for it to operate in the country.
What did we learn ...

- Expansion in regions where bank had no presence was very short-sighted.
- Product structure and offering, more often than not, self selects the population:
  - Offering of “Premium Miles” cards, customers self select.
  - Offering a cash upfront with ability to withdraw cash from a revolving facility...you tend to attract cash hungry customers
- Expanding in locations or regions with no collections capabilities presents real challenges
- Risk assessment and pricing to reflect nature of a product is critical:
  - Assessing a revolving cash product the same as an instalment loan masks the risk of the customer.
  - Cash transaction in credit cards are a critical driver of customer behaviour and their credit scoring.
Case Study #3
Savings & Loans
Mortgage Bank

United Kingdom
## Case Study # 3

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<td>• UK Building Society (residential mortgage lender owned by its savers and borrowers) founded in 1965 who had converted to a publicly listed bank in 1997.</td>
<td>• Strategy was to become country’s 3rd biggest mortgage provider.</td>
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<td>• Next 10 years: yearly growth in assets which saw it become the country’s 5th biggest mortgage provider, despite its small branch network.</td>
<td>• Differentiating factor with other “retail” banks was to rely on wholesale markets rather than retail deposits to finance most of the lending book.</td>
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<td>• Bank’s loan book appeared good: arrears were half of industry average @ June 2007.</td>
<td>• Highest reliance on Securitisation amongst all UK banks.</td>
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<td>• Sep 2007: Securitisation market starts to fall out. Bank share price slides as investors worry about prospects for mortgage lenders given the fallout of the US excessive subprime lending.</td>
<td>• YE’06: 7% market share of UK mortgage loans.</td>
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<td>• H1’07: lending soared by 31% (net of redemptions). Market share of new lending increased to 19%.</td>
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What Happens Next?

• June 2007: First profits warning. Bank had agreed to issue tranche of mortgages at interest rates lower than its financing costs. This highlighted vulnerability of reliance on wholesale funding. Share price falls further.

• August 2007: BNP Paribas freezes assets of hedge funds exposed to US subprime market, causing increased volatility/concerns across global markets. Global securitisation market effectively freezes. Interbank market seizes as none of banks no longer trusts each other.

• Q3’07: Run on the Bank – the first on a UK high stress bank since the 1860s.

• ~Nov 07: Bank of England finally announces it is acting as lender of last resort. Damage already done.

• Another 5 months before Bank was nationalised.

• UK Banks Regulatory oversight was flawed: power shared by the Treasury, the Bank of England (monetary policy) and the Financial Services Authority (supervision and oversight). No regime/protocol in place to tackle bank failures.
What did we learn?

• Heavy reliance on wholesale funding is not clever. It may be cheaper and faster than acquiring retail deposits, but it also disappears quickly and is more costly in the long run.

• Liquidity is King and, lack of is usually what brings financial institutions down.

• Regulators do not know everything! Falling share price + huge increase in market share + profit warning should have sounded big alarm bells to the regulators ... In this case they were asleep!

• Crisis planning must be more than wishful thinking! Stress testing is important and should be part of any strategy “validation” and crisis planning.

• Understanding what banks are up to is important: how do they earn their money, how do they manage their balance sheet, how do they fund themselves, etc ... Do not rely only on important but ultimately superficial data. For example, high market share is not equal to high credit quality or low default probability.
Case Study #4
Oil & Gas

United States
Case Study # 5

**Background**

- Large energy company created through a series of mergers with other regulated utilities.
- US$ 60bn powerhouse with power generation, transmission and trading entities in almost 40 countries.
- Wall Street favourite trading at +50x p/e ratio, voted Fortune 500 “America’s most innovative company” between 1996 and 2001.
- Asset heavy regulated company moving into unregulated markets requiring significant working capital.
- Significant off-balance sheet financing used.
- Complete set of financials audited by leading global accounting firm.

**Transaction**

- US$ 200m 5 yr revolving credit facility
- Term loan to an associated special purpose vehicle (SPV)
- US$ 100m 2 year commodity derivatives facility

? As the credit officer, what are the key questions you raise to support an appropriate structure to manage the risks?

? What are the key structuring features?

? What is your view of this transaction?
What Happens Next?

• 1990: Finance subsidiary was formed to handle all funding and capital markets transactions.
• 1992: Accounting method for derivatives transactions moved to mark-to-market (ie fair value).
• January 2001: Stock peaked at 70x earnings (comparable???)
• March/April 2001: Fortune 500 published article questioning earnings quality. Wall Street follows suit.
• August 2001: Anonymous internal memo to CEO which was also leaked externally cited: “... worst accounting fraud ever seen ... ruin was stalking the company”.
• Whistle-blower identified SPVs which had been used to “hedge” various company assets.
• SPVs capitalised using company’s own shares and carrying ~US$ 700m of losses by Q3’01.
• October 2001: Company restated its earnings statement. Market liquidity started to dry up.
• November/December 2001: Full scale liquidity crunch resulting in company entertaining various merger discussions.
• December 2001: Merger discussions collapse, external ratings downgraded to junk, Chapter 11 filing.
• 2006: Bankruptcy finalised.
What did we learn?

- Company grew far too quickly. Growth in trading operations created huge market sensitivity – the demise of such concentration would have large ripple effect across the market.
- Understanding a company’s culture and where their red line is important.
  - Highly decentralised and “entrepreneur” culture with arrogant management that could not be questioned and pushed accounting rules too far.
  - Company’s senior executives fooled regulators with fake holdings and dubious accounting practices.
- SPVs are opaque vehicles, and understanding where they stand in a corporate structure and how they are funded is key.
- Company used SPVs to hide its mountains of debt and toxic assets from investors and creditors.
- Conflicts of interest between auditors and clients need to be carefully managed.
- Understanding basics of what a company does day to day – the actual “doing” day to day.